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SUBJECT: FRANCE IN THE FINANCIAL CRISIS

REF: 22 OCTOBER JKESSLER EMAIL TASKING

¶1. (U) Per ref tasking, this message provides an initial read on France and the financial crisis, including immediate credit/liquidity concerns, the longer macroeconomic outlook, government actions in response to the crisis, expected domestic impact and possible effects on U.S.-French relations.

Immediate Concerns Stemming from the Financial Crisis

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¶2. (U) Following a virtual freeze in interbank lending early in October, interbank interest rates began to ease at mid-month and regulators indicate that volumes are picking up. While the European Central Bank cut its key interest rates by 50 basis points, interbank interest rates have decreased 30 basis points. Steps taken by the French government and its European partners to address liquidity problems in the banking system and restore confidence have indirectly contributed to unblocking the interbank market.

¶3. (U) The outstanding amount credit in the French economy (1,845 billion euros or USD 25,827 billion) increased at a 10.2 % annual rate in August, compared to 14.2 % in the first months of 2008. The amount of credit to households in August was up 8.3% compared to the summer 2007, despite a sharp decline in home mortgage loans (down 26.3% y/y in Q3 2008).

¶4. (U) As business conditions have worsened and economic growth has flagged, the number of companies in bankruptcy has jumped 17.2 % to 11,400 in the third quarter, compared with a year earlier. All sectors are affected. According to the research firm Altares, the number of bankruptcies could reach 53,000 in 2008, a ten-year record. One in four bankruptcies resulted from cash-flow problems. French business is complaining that banks are cutting off lines of credit when credit insurers downgrade company ratings, sometimes without notice.

Longer term macroeconomic effects

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¶5. (U) Economic growth is slowing to a near halt. The Bank of France puts provisional Q3 GDP growth at -0.1% and the IMF projects 0.2% growth in 2009. An official survey of status of French industry shows the bleakest outlook since the depths of the 1993 recession. Overtime hours worked are down and unemployment has begun to increase (currently 7.6%) for the first time since 2003. Nevertheless, consumer spending rose slightly in Q3 after showing zero growth in Q2.

Actions to Address the Financial Crisis

¶6. (U) In late September, President Sarkozy called for an international summit on restructuring of international financial and economic institutions (a "new Bretton Woods") to deal with the world financial crisis and prevent future crises. He convened his European G-7 counterparts to attempt to reach agreement on an approach to the crisis, in advance of the G-7 Finance Ministers meeting in Washington. On October 12, he invited UK Prime Minister Brown and leaders of the Eurozone countries to Paris to formulate a coordinated approach to shoring up banks and guaranteeing deposits. He obtained EU-wide endorsement for this approach, and for holding a summit on restructuring the international financial architecture, at the October 15 Q 16 European Council.

¶7. (U) Based on the Eurozone agreement of October 12, the French government passed legislation that made available up to 320 million euros in guarantees for medium-term financing (up to five years) for banks, and another 40 billion euros for recapitalization. The financing is channeled through a cooperative limited stock company, with public participation, that will issue its first bond the week of October 27. Thanks to a bridge loan it will extend its first credits this week. The recapitalization fund covers the 3 billion euro

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capital injection for the Franco-Belgian bank Dexia, commensurate with the terms of the intergovernmental agreement signed on October 8 with Belgium and Luxembourg.

¶8. (U) In addition, the government and the six largest French banks announced a plan on October 21 that would inject 10.5 billion Euros into their capital by end of year. The official objective is to enable the banks to continue to supply credit to households, small businesses and groups affected by the financial crisis. But the move will also strengthen the banks' balance sheets, thus improving their ability to raise funds on the open market.

Domestic Political and Economic Implications

¶9. (SBU) President Sarkozy has acted decisively in France, and as president of the European Council, over which he presides until the end of the year. While economic stagnation potentially complicates his ability to press forward with reform, his financial sector and international initiatives have boosted his stature domestically, and may bring his presidency additional political capital.

Consequences for Bilateral Relations

¶10. (SBU) French officials frequently make the matter-of-fact observation that "this crisis didn't start in France." But they consider it a global problem and have sought a constructive approach in resolving it together. Nevertheless, President Sarkozy is going beyond the immediate and proximate causes in his calls for reform of the international financial system. His Gaullist economic instincts, combined with his activism, will inevitably lead to differences as the Summit process moves forward, particularly for the remainder of the French EU presidency. We will need to continue to consult

frequently with the French to keep our common agenda well-focused.

¶11. (SBU) The economic slowdown is likely to further exacerbate what is already a challenging budgetary environment. While relaxation of budget strictures is not out of the question, from defense to development assistance the GOF will be under the gun to rein in spending in areas that are important to us. We will need to consider this as we build assumptions about the burdens the French will or will not be ready to assume in a number of critical areas.

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